STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Consumers Illinois Water Company	:	
	:	03-0403
Tariffs seeking general increase in water	:	
rates for the Kankakee Water Division.	:	

REPLY BRIEF OF THE STAFF OF

THE ILLINOIS COMMERCE COMMISSION

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NOW COMES the Staff of the Illinois Commerce Commission ("Staff"), through its undersigned counsel, and files its reply brief in the above referenced docket.

I. RATE BASE

A. Grant Park Acquisition

The Company argues that Staff is disregarding a symmetry to ratemaking by proposing that the Company's rate base reflect depreciation on the Grant Park water system assets during the October 2001 through April 2003 period. Because the Company does not recover the accompanying depreciation expense during that same time period, the Company does not agree with Staff's proposal. (CIWC Brief, p. 4) The Company further argues that a deduction of accumulated depreciation from rate base without a corresponding recovery of depreciation expense results in a deduction from rate base of investor supplied funds, or a denial of opportunity to earn a return of all of the Company's investment. (Id., p. 5)

Staff agrees with the Company's premise that depreciation expense is recovered from ratepayers, therefore accumulated depreciation should reduce rate base because it represents non-investor supplied funds. However, the remainder of the Company's argument does not logically follow. While, it is true that Staff's proposal does not allow the Company to recover the depreciation expense (or increase in accumulated depreciation) that Staff proposes to be recognized for the period October 2001 through April 2003, the Company did not own the assets during this period. Thus, it was not a Company expense that is properly recoverable from ratepayers. No one argues that the Company should be able to earn a return on the depreciation accumulated prior to October 2001. Nevertheless, Company argument, if carried through to its illogical conclusion, would suggest that none of the accumulated depreciation, including that prior to October 2001, should reduce rate base as it represents depreciation expense that has not been recovered from the ratepayers. It cannot be emphasized enough, the Company did not own the assets prior to April 2003, so none of the accumulated depreciation correctly recorded as of the acquisition date represents investor supplied funds, nor should a return on it be recovered from the ratepayers.

The Company also argues that, "[i]f an adjustment is made to one part of the entries (Reserve for Depreciation), other parts of the entry such as Utility Plant, CIAC or cash, may need to be updated. However, because there is no record of what those changes might be, only a guess can be used for changes to the entry." (CIWC Brief, p. 5) This argument is inaccurate hyperbole. Staff witness Sant has calculated a reasonable balance for these accounts as of the acquisition date. The result of this calculation is included in the record at ICC Staff Exhibit 7.0, Schedule 7.07, page 2. Although the Company has made clear its position against recording the correct depreciation amount, the record does not include any disagreements by the Company with the mechanics of Mr. Sant's calculation. As shown in Mr. Sant's schedule, the utility plant and CIAC account balances are identical to the amounts shown by the Company on page 3 of its Initial Brief. The original cost of the assets is what it is and does not change. Similarly, the cash amount is identical. Unless the Company paid a different amount than reported, there is no reason to change the "cash" portion of the equation. Therefore, the only amounts that reflect a difference between the Company's and Staff's proposal are the depreciation and amortization amounts, which are at the heart of this disagreement; and the acquisition adjustment, which, by nature, is simply a residual amount based on the other account balances in this entry. There is no guesswork, as suggested by the Company.

The Company summarizes its arguments against Staff's proposal by stating it violates the Commission's Order in Docket No. 02-0480 and it creates a ratemaking mismatch between depreciation expense and accumulated depreciation which would result in the Company not earning on a portion of its investment. (CIWC Brief, p. 5) As more fully explained in Staff's Initial Brief, Staff's proposal is entirely consistent with the Findings in the Order in Docket No.

02-0480. (Staff Brief, p. 3) As discussed above, Staff's proposal does not result in the Company not earning on a portion of its investment. The Company has no claim to the depreciation expense that should be rightfully recorded between October 2001 and April 2003, because the Company did not own the assets during that time.

II. OPERATING REVENUES AND EXPENSES

A. Wages and Salaries

The Company continues to challenge Staff's Adjustment to vacant budgeted employees. The Company also offers the alternative of including overtime wages in revenue requirement in the event that Mr. Smith's adjustment to eliminate unfilled budgeted positions is granted. (CIWC Brief, pp. 6–7)

The Company's newest argument against the elimination of unfilled budgeted employee positions is that the Company will incur additional overtime expense in lieu of wage expense for the unfilled vacancies. (CIWC Brief, p. 6) The question of additional overtime expense was not posed until the surrebuttal phase of this proceeding and Staff has had no opportunity to fully investigate this issue. The Company provided little empirical evidence supporting its position, only a couple of numbers within the text of surrebuttal testimony, and Staff has had no practical opportunity to issue data requests or otherwise confirm the claims of the Company's witness.

However, the Company's position is questionable on its face. As discussed in Staff's Initial Brief, over time expenses are routinely incurred at a full complement of employees. This is because it is sometimes reasonable to have a full time employee work extra hours rather than to hire a temporary employee for a few hours of work. Additionally, it is reasonable to expect that the budget process provides for the inclusion of overtime wages. (Staff Brief, p. 9) The Company is attempting to improperly shift the burden to Staff while at the same time withholding the information that Staff would need to analyze the Company's claim. The record in this docket is incomplete as to overtime expense.

The Company wrongly suggests that there is a connection between Mr. Smith's adjustment and the fact that he did not compare the number of employees per customer at CIWC with other utilities. (CIWC Brief, p. 6) The number of customers at other utilities is irrelevant to the cost of providing service to the customers of CIWC. Any similarity, or difference, between an employee to customer ratio at CIWC and an employee to customer ratio at any other utility is purely coincidental, unless CIWC's costs are incurred by that other utility on behalf of CIWC. The significance that the Company attempts to draw from this "connection" is misplaced and misleading.

CIWC has failed to explain, or really even address in its brief, why Staff's unfilled employee position adjustment should not be made. Furthermore, any suggestion that overtime expenses should be increased if the unfilled employee position adjustment is made is without a full review and adequate support in the record. It is Staff's position that Mr. Smith's unfilled employee position adjustment should be accepted and that the Company's proposal to increase overtime wage expense be denied. (Staff Brief, pp. 8-11)

B. Employee Benefits

The Company argues that an increase in overtime will result in increased benefits and tax expense. (CIWC Brief, p. 8) Staff does not necessarily disagree with this point. However, the Company has not proven that future actual overtime expenses under normal conditions will be different than the test year level. Further, the Company has not identified, let alone proven, the amount of change in employee benefits expense associated with any speculative change in overtime. There is no evidence to support the Company's position on this point.

Staff readily acknowledges that if its unfilled position adjustment is rejected, the Employee Benefits adjustment should also be properly adjusted for additional positions. (Staff Brief, pp. 11-12)

C. Incentive Compensation

CIWC's brief begins by noting that Staff witness Smith did not compare CIWC's wage expense with other utilities' wage expense. (CIWC Brief, p. 9) Staff is hesitant to even address this irrelevant factor. But, for purposes of argument, Staff notes that if CIWC's cost of operations were dependent upon the cost of operations of other utilities, then it might be reasonable to compare CIWC's costs to those other utilities. While comparisons with other utilities might provide fodder for lively discussion, the cost of operating CIWC's Kankakee division was the focus of Staff's review. It is CIWC's cost that Staff has reviewed for the purpose of developing a sound record. If the Company was concerned about the cost of operating other utilities, the Company witness could have provided that information for the record.

CIWC's Brief states, "(t)he bottom line is that regardless of whether incentive compensation is paid annually or whether the Commission has previously included bonuses in cost of service, Mr. Smith does not believe that employees should have bonuses." (CIWC Brief, p. 9) While Staff accepts that this is an accurate portrayal of the transcript, it is an irrelevant point to the issue. The parties care not what Mr. Smith's personal belief might be regarding the propriety of bonuses. Rather, the point to be considered is should bonuses be included in revenue requirement. The fact is, the Company has provided no <u>evidence</u> to support the proposition that the payment of bonuses is beneficial to customers. The necessity of passing a benefits test was clearly reaffirmed by the Commission in the order in Illinois American Water Company Docket 02-0690 which stated,

> Generally speaking the Commission believes that if a utility is seeking to recover such projected expenses from ratepayers, the utility should demonstrate that its plan can reasonably be expected to provide net benefits to ratepayers. (Order, at 19)

CIWC's comment that, "(i)t is difficult to discern if Mr. Smith objects to deferred compensation because he believes it <u>will not</u> be paid or because he believes that it <u>will</u> be paid", (CIWC Brief, p. 9), indicates a lack of familiarity with Mr. Smith's testimony. Mr. Smith was very clear as to his concern.

> If actual costs turn out to be greater …, then the bonuses will not be paid, and net income for stockholders will be impacted in a positive manner … . If actual costs are maintained at the maximum reasonable level, then bonuses will be paid without reducing the authorized income available to stockholders. (ICC Staff Ex. 8.0 p.11)

"The customers pay regardless". (ICC Staff Ex. 8.0, p 12) It is clear, that both scenarios are unacceptable.

The Company's argument, that it should be allowed to recover incentive compensation because it actually awards the payments, rings hollow. CIWC cannot rationalize the inclusion of incentive compensation expense in revenue requirement based on the fact that the Company has made incentive compensation payments for 8 years. The identification of expenditures does not equate to justification for the same.

In its Brief the Company, without providing specific examples, indicates that the Commission has consistently allowed for the inclusion of incentive compensation expense in revenue requirement. (CIWC Brief, p. 9) A review of Commission decisions actually proves contrary to the Company's contention. The Order in CIWC Docket 95-0307/0342 consolidated denies recovery of incentive compensation. (Order, at 26) As recently as last year in Illinois-American Water Company Docket 02-0690 the Commission reaffirmed its consistency in denying incentive compensation when the Commission stated,

> (a)s noted on pages 18-19 of the Commission's order in 00-0802, "the Commission has generally disallowed such expenses except where the utility has demonstrated that its incentive compensation plan has reduced expenses and created greater efficiencies in operations." (Order, at 19)

In this docket the CIWC has failed to demonstrate "that its incentive compensation plan has reduced expenses and created greater efficiencies in operations." Other Dockets which deny the recovery of incentive compensation plans include CWIC Docket 95-0641, Citizens Utilities Company Docket 94-0481, CILCO Dockets 94-0040 and 01-0465/0530/0637 consolidated, Mid-American Energy Company Docket 99-0534.

The Company's brief fails to address Mr. Smith's concern that incentive compensation encourages the Utility to pay its employees to maintain low costs even though the employees are required to keep costs at a reasonable minimum. (ICC Staff Ex. 8.0, pp 11-12) Rather, the Company attempts to justify its position by arguing that the Company really does make the incentive compensation payments. For reasons more fully developed in Staff's brief, Mr. Smith's adjustment for incentive compensation expense should be accepted. (Staff Brief, pp. 12-14)

D. Charitable Contributions

In its Initial Brief, the Company argues that Staff witness Sant confuses the Company's contributions to community and economic development organizations with dues paid to these organizations. The Company argues that since these costs are not dues, they are recoverable as charitable contributions. Furthermore, the Company argues that the prior Commission Orders cited by Staff, which consistently state that dues to community and economic development organizations should be borne by the shareholders, are irrelevant because those Orders only address dues, not contributions. (CIWC Brief, p. 14) The Company misses the point entirely.

The Commission has previously determined that, while companies should interface with these kinds of groups, the shareholders should bear the cost. (Commission Order 90-0169, March 8, 1991, p. 65-66). Even assuming these costs are something other than dues (and the Company has not shown this to be the case), the Company fails to explain why, if dues are not recoverable, costs in addition to dues are recoverable.

The Company acknowledges that the payments are made to support these organizations in their normal operations. There is nothing to distinguish between paying an organization's dues, to support its operations, and in paying an additional amount to the organization in order to support its normal operations. The Company's own words defeat the Company's argument. In Staff Cross Exhibit 1.0, which includes the Company's response to Staff data request BCS 2.9, the Company states:

> Answer: The metropolitan area that the Kankakee Division serves includes two separate Chambers of Commerce. The Kankakee River Valley Chamber of Commerce focuses on the city of Kankakee and the Village of Aroma Park areas of the service territory. The Bradley-Bourbonnais Chamber of Commerce focuses on the Bourbonnais and Bradley area of the service territory. Both organizations however work on projects and coordinate their efforts on projects that affect the entire area. **The contributions to the Bradley-Bourbonnais and Kankakee River Valley Chamber of Commerce are to support these two organizations that promote the area to attract development in residential housing, commercial entities and industrial/manufacturing**

> **businesses and to provide a networking framework for local businesses to communicate to each other.** These organizations are advantageous to the Company's existing customers by providing a framework of communication and networking within the business community. They also promote growth in the community which is advantageous to the current Company's customer base by having the ability to spread fixed costs to more customers.
> The Kankakee County Economic Development Council is comprised entirely of businesses that are involved in the economic well being of the community. **The Council focuses on the needs of the current businesses in the community. It works with governmental entities in supporting the effort to retain the local businesses to keep the community as healthy as possible. In addition, they are involved in attracting new businesses to the area. The council is supported by the member's pledges and dues payments each year.** (Emphasis added).

As explained in the Company's response, the payments are made to support these organizations in their normal operations. The Company fails to provide a compelling explanation as to how its practice of making payments to support the organizations in their normal operations is distinguishable from paying dues to the organization.

The Company's other main argument relates to its discussion of Section 9-227 of the Public Utilities Act. Once again, the Company's own words defeat its argument. After citing this section of the Act, the Company states, "[a]s Company witness Schreyer explained, 'the relevant consideration is whether the purpose of the donation is for charitable scientific, religious, or educational purposes' and 'the contributions are reasonable comprising less than .4% of revenue'." (CIWC Brief, p. 13) Nothing in the Company's response listed above indicates that these payments, whether rightly regarded as dues or contributions, are for “scientific, religious, or educational purposes.”

As stated in Staff’s Initial Brief, the Company has failed to provide compelling reasons why the Commission should differ from its consistent position of disallowing such expenses (dues to community and economic development organizations) from the revenue requirement. Further, as demonstrated above, the Company’s arguments are misguided and unpersuasive. Therefore, the Commission should adopt Staff’s proposal to disallow certain fees paid to community and economic development organizations disguised as charitable contributions.

E. Advertising

The Company’s argument concerning Staff’s proposal to disallow goodwill advertising misrepresents the facts of this case.

First, the Company states, in referring to Mr. Sant, “[h]e determined that several (23/60) of the advertisements are goodwill or promotional in nature, but does not explain, describe or attach what the ads in this category are.” (CIWC Brief, p. 16) This is incorrect. Mr. Sant identified the specific ads he determined to be goodwill in nature on ICC Staff Exhibit 5.0, Schedule 5.07, Page 2, Source 4. The Company was unable or unwilling to identify the costs associated with the specific advertisements Mr. Sant identified. It was in response to the Company’s failure to provide the necessary information that Mr. Sant applied his ratio to the Company’s advertising expense in order to calculate his adjustment. The

Company is now somehow able to take the results of this ratio and equate the amount with specific advertisements, which are not the advertisements Mr. Sant proposed to disallow. On that basis, the Company then accuses Mr. Sant of wrongly disallowing those advertisements. The Company's argument is ludicrous and should be given no weight by the Commission. The facts are clear. The Company acknowledged that some of its advertisements are goodwill in nature. (CIWC Ex. R-2.0, p. 8) Mr. Sant's adjustment is the only reasonable quantification for the cost of these advertisements.

Second, the Company provided Mr. Sant only 37 advertisements, not 60 as stated by the Company.

Third, the Company mischaracterizes Mr. Sant's testimony so it can accuse Mr. Sant of being inconsistent about whether or not he reviewed advertisements. (CIWC Brief, p. 17) As explained in his testimony, Mr. Sant asked the Company to provide him with scripts of its historical advertisements. After reviewing these scripts, he determined that many were goodwill and identified those specific advertisements. (ICC Staff Ex. 5.0, p. 3) Given that the scripts for the program ads were included in the data request response sent to Mr. Sant, there is no inconsistency as Mr. Sant reviewed all scripts sent to him. If the Company failed to include the scripts for the program ads, therefore preventing Mr. Sant from reviewing specific program ads, the problem lies with the Company, not Mr. Sant. The Commission should not reward the Company for its failure to completely and accurately respond to Staff's data requests.

Finally, the Company argues that Staff's proposal should be disregarded because Staff is confusing large company mega ad campaigns with the Company's reasonable donation to charity. (CIWC Brief, p. 18) The Company has offered no reasoned basis why the size, rather than the nature, of an advertising campaign should determine whether its costs are recoverable. The Commission should reject this novel argument on its face. Furthermore, it is inappropriate to characterize these payments as charitable donations. In exchange for the payments, the Company received services and benefits in the form of advertising. (ICC Staff Ex. 7.0, pp. 12-13). Nowhere has the Company denied this fact. Furthermore, the Company's charitable donation argument, at best, applies to only a small portion of Staff's adjustment. The amount of advertising expense the Company attempts to reclassify as charity is only $1,885 of the $18,667 in total advertising expense. Because Staff's adjustment uses a ratio, 62.16%, to propose disallowance of goodwill advertising, Staff's proposal disallows only $1,172 (62.16% of $1,885) of the 'charitable' program ads. Staff's total adjustment is for a disallowance of $11,491. The difference between the total proposed disallowance and the $1,172 is $10,319. The Company makes absolutely no argument in its Initial Brief as to why the remaining $10,319 of Staff's proposal should be disregarded.

In sum, Mr. Sant identified specific advertisements that are goodwill or promotional advertisements. The Company was unable or unwilling to provide the information necessary for Mr. Sant to remove the costs of these specific advertisements. Lacking any better alternative, Mr. Sant quantified his adjustment by determining the ratio of goodwill advertisements to total advertisements and applying that ratio to total advertising dollars. The Company has acknowledged that some of its advertisements are in fact goodwill advertisements, yet refuses to accept any adjustment to remove the cost of such advertisements. For these reasons, the Commission should adopt the Staff position.

F. Rate Case Expense

The Company argues that Staff's adjustment to rate case expense is fallacious, because Staff witness Sant "merely assumes that if the Company overestimated the rate case expense in its last rate case, which settled, then it would also overestimate its rate case expense in the current case, which is being litigated, and, that the overestimate would be proportionate to the last case." (CIWC Brief, p. 19)

Again, the Company mischaracterizes Mr. Sant's testimony. Mr. Sant states in his direct testimony that he finds it appropriate to propose a reduction to rate case expense because the amount has not been supported by the Company. Mr. Sant then explains that he has two reasons to question the accuracy of the estimated amount. First, it represented a 26% increase from the estimated amount in the prior case. Second, the prior case amount was overestimated by 14%. (ICC Staff Ex. 1.0, p. 14) As such, despite the Company's arguments to the contrary, the basis for Mr. Sant's proposal is not that the prior case's cost was overestimated. The fact that the Company overestimated the cost for the prior rate case is merely one of the factors that caused Mr. Sant to question the Company's estimate and ask the Company for additional support. It is the Company's failure to provide the support for which Mr. Sant asked that forms the basis for Mr. Sant's adjustment. The Company has provided support for the amounts it spent at specific points in the case, but has provided no support for its overall estimate, which is the amount in question.

The Company argues that Staff's adjustment is flawed because Staff's proposed amount did not change "even though it is apparent that actual rate case expense would increase as the Company prepared rebuttal and surrebuttal testimony, continued to respond to Staff discovery, and prepared for and participated in hearings." (CIWC Brief, p. 19) This argument is baseless. Staff had no reason to refine its proposed adjustment amount. Furthermore, this argument would apply to the Company's proposal as well. The Company never revised its $195,000 amount. Ironically, the logic behind the Company's argument, if accepted, would preclude the Company from recovering any rate case expense in this case. Both Staff's and the Company's proposals would be flawed, because the proposed amounts never changed. Mr. Sant calculated what he deemed a reasonable amount for the overall rate case expense, not a moving target that would change at every phase of the case. As is discussed more fully below, the Company did not provide anything subsequent to Staff's proposal to support the contention that its estimate of $195,000 was more reliable than

Staff's estimate of $167,000.

As Staff explained in its Initial Brief, the provision of a cost amount at a particular point in time does not serve to support the overall estimated amount. Also explained in Staff's Initial Brief was the fact that Staff repeatedly asked the Company to provide updated projections of its rate case expense that specifically showed comparisons between actual expenses and projected expenses at different points within the proceeding, but it failed to do so. (ICC Staff Brief, p. 20) In his direct testimony, Mr. Sant explained why he had concerns about the Company's estimated cost amount and identified specific information the Company could provide to address his concerns. Mr. Sant stated, "To better support its estimate, the Company should provide Staff with more tangible support, such as a comparison of up-to-date actual costs versus estimated costs." (ICC Staff Ex. 1.0, p. 15) For instance, if the Company had provided support to show that it projected to spend $150,000 or less prior to the evidentiary hearing, or support that specifically showed it projected to spend at least $45,000 (the difference between $150,000 and its estimated $195,000) during the evidentiary hearing and briefing phase of the proceeding, then Staff would have been able to evaluate how at various stages of the case actual costs compared to the Company's estimate at each of those stages of the case. However, as explained in Staff's Initial Brief, the fact that the Company spent $150,181 through November 30, 2003, in isolation, does not support its estimate of $195,000 any more than it supports Staff's estimate of $167,000.

The Company summarizes its argument by stating, "[w]ith the Staff concern and the Staff adjustment based on the Company's last case, which resulted in lower rate case expense because it was settled, the Staff adjustment should be rejected." (CIWC Brief, p. 20) The Company essentially argues that since it settled its last rate case, the Company does not need to support its rate case expense estimate for this case. The Company is wrong. Staff, in its direct testimony, explained the support the Company should provide. The Company chose not to do so. As explained in Staff's Initial Brief, the Company simply "updates" its projection, and each time uncannily projects that it will spend exactly $195,000. (ICC Staff Brief, p. 19)

The Commission should not accept the Company's arguments. In essence, the Company has argued that Staff's proposal is wrong because the Company settled the prior case but not the instant one, therefore, whatever it estimates, whether supported or not, must be accepted. Staff has demonstrated that the Company did nothing to demonstrate that its cost amount was superior to Staff's. The Commission should accept Staff's proposal, which reasonably gives the Company more than it estimated in its prior case, yet does not give the Company it's full, unsupported estimated amount.

IV. COST OF CAPITAL/RATE OF RETURN

A. Cost of Common Equity

Staff continues to differ with the Company regarding CIWC's cost of common equity. Staff's Initial Brief detailed flaws in Ms. Ahern's analysis and how her methods have been rejected in previous Commission Orders. In this Reply Brief Staff will expose the spuriousness of the Company' criticisms of Ms. Kight's cost of equity recommendation.

1. Staff's Recommendation

The Company cites to the fact that rate of return on equity granted to Illinois American Water Company ("IAWC") in its recent rate case increased from the return granted in IAWC's previous rate case, as support for its claim that its own return on equity should not have fallen since its last rate case. The Company conjectured that the difference in the Staff rates of return on equity ("ROEs") for the two companies is due to Ms. Kight's conclusion that CIWC's financial strength is commensurate with a strong A rating rather than a BBB rating. (CIWC Brief, pp. 32-33) The Company's assumptions are erroneous. Staff used the same methodology to determine the cost of equity in Docket No. 02-0690 as it did in this case. (See Order, Docket No. 02-0690, August 12, 2003, pp. 78-79) While the average beta for the IAWC water and utility samples (i.e., 0.55)[1] is nearly identical to that for the CIWC water and utility samples (i.e., 0.548) and the estimated risk-free rate increased slightly from 5.24% to 5.50%, the required rate of return on the market portfolio declined between December 4, 2002, when the analysis for IAWC was performed, and August 11, 2003, when the analysis for CIWC was performed. (Tr., pp. 191-193; Order, Docket No. 02-0690, August 12, 2003, p. 79; ICC Staff Ex. 3.0C, Sch. 3.09) If the CAPM analysis for IAWC had been performed with data from August 11, 2003, the

[1] Order, Docket No. 02-0690, August 12, 2003, p. 79. "Ms. Kight estimated forward-looking betas of 0.52 for the water sample and 0.58 for the utility sample."

estimated cost of equity would have been 9.99%.[2] The extreme closeness of that estimate to Ms. Kight's 9.97% CAPM cost of equity estimate for CIWC[3] confirms that the principal difference between IAWC's CAPM cost of equity estimate and CIWC's CAPM cost of equity estimate is the decline in the required rate of return on the market portfolio from 14.8% in Docket No. 02-0690 to 13.66% in the present case. (Order, Docket No. 02-0690, August 12, 2003, p. 79; ICC Staff Ex. 3.0C, pp. 25-26 and Sch. 3.09)

Ms. Ahern agreed that the required return on the market has declined. She estimated her forecasted market required rate of return as the sum of the dividend yield and appreciation potential published by Value Line. (CIWC Ex. 3, Sch. 14, p. 4) She testified that both the dividend yield and appreciation potential published by Value Line have decreased since she conducted her analysis, specifically the appreciation potential was 80% on November 29th, 2002, 75% May 30th, 2003, 50% August 29th, 2003, and 45% November 28th, 2003. Ms. Ahern also testified that if she were to update her analysis, her recommendation would decline. (Tr., pp. 191-193) Furthermore, although the IAWC DCF analysis cannot be updated since all the necessary data is not available for August 11, 2003, the decrease in the DCF estimate from 10.02% in IAWC's recent rate case

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[2] ICC Staff Ex. 3.0C, Sch. 3.09. Since the average beta Staff estimated in Docket No. 02-0690 for IAWC is nearly identical to the average beta Staff estimated in this proceeding for CIWC, this updated calculation for IAWC changes only the risk-free rate (R_f) and required rate of return on the market (R_m) parameters of the CAPM. The results of the CAPM analysis for IAWC as of the August 12, 2003 date used for the CIWC analysis is as follows: IAWC Water Sample = 5.5% Risk-free rate + .52 Beta x (13.66% Market return – 5.5% Risk-free rate) = 9.74%; IAWC Utility Sample = 5.5% Risk-free rate + .58 Beta x (13.66% Market return – 5.5% Risk-free rate) = 10.23%; IAWC CAPM estimate for return on equity = (9.74%+10.23%)/2 = 9.99%.

[3] ICC Staff Ex. 3.0C, p. 30 and Sch. 3.09. The CAPM estimate of return on equity is (Water Sample 9.58% + Utility Sample 10.36%)/2 = 9.97%.

to 9.75% is consistent with the decline in the CAPM estimate which Staff has shown is primarily due to the decline in the investor-required rate of return on the market. This information clearly shows that the decrease in the recommended cost of equity between this case and IAWC's recent rate case is explained by a general decline in investors' rate of return requirement, not Ms. Kight's use of an implied S&P credit rating.

The Company asserted that over the "same period," IAWC's ROE increased 10 basis points while CIWC's ROE declined by 29 basis points. This argument is disingenuous. (CIWC Brief, pp. 32 & 36) IAWC's and CIWC's changes in ROE did not occur over the "same period" of time. While IAWC and CIWC filed their 2000 rate cases and received Commission orders in those dockets within days of each other, eight months separate IAWC's latest tariff filing from CIWC's latest tariff filing. CIWC has previously benefited from the degree to which the cost of equity can change in a period of eight months. The table below summarizes the current CIWC rate case, the recent IAWC rate case, and two past CIWC rate cases.

Docket Number	Company	Tariffs Filed	Final Order (Date & page)	Recommended/ Approved Cost of Equity
03-0403	Consumers Illinois Water Company	May 21, 2003		9.86% (Staff Recommendation)
02-0690	Illinois-American Water Company	September 20, 2002	August 12, 2003, p. 82	10.27% (Approved)
99-0288	Consumers Illinois Water Company	April 30, 1999	March 1, 2000, p. 21	10.5% (Approved)
98-0632	Consumers Illinois Water Company	August 13, 1998	March 24, 1999, p. 5	9.8% (Approved)

As the table above shows, from 1999 to 2000, the cost of common equity the Commission approved for CIWC increased 70 basis points between rate filings that were only eight months apart and order dates that were under a year apart. Thus, even if one were to assume that IAWC and CIWC are similar in risk, history demonstrates that over a period of eight months, the cost of common equity can change far more than the 41 basis point difference in the Commission authorized (and Staff recommended) rate of return on common equity for IAWC and the Staff recommended rate of return on common equity for CIWC.

The Company argues that Ms. Kight should have used the Company's NAIC rating in her cost of equity analysis. That assertion is both problematic and disingenuous. Reliance on an NAIC rating is problematic for the following reasons. First, NAIC does not rate companies such as CIWC; NAIC only rates specific securities issues. Specifically, the NAIC "is responsible for the day-to-day credit quality assessment and valuation of securities owned by state regulated insurance companies." (Tr., p. 214) Of CIWC's ten long-term debt issues, Ms. Ahern testified that she only has knowledge of three issues with an NAIC rating. (Tr., p. 184; ICC Staff Ex. 3.0C, Sch. 3.03)

Second, the NAIC rating for those three CIWC debt issues is uncertain. Ms. Ahern did not receive the NAIC rating directly from NAIC, but relied on the information the Company provided. (Tr., p. 185) The Company's source for the alleged NAIC ratings was not placed in the record. Therefore, the NAIC ratings cannot by verified. Even if the ratings could be verified, the NAIC does not intend them to be used by investors. The NAIC's website clearly states, "[t]hese designations [ratings] and unit prices are produced solely for the benefit of NAIC members… Unlike the ratings of nationally recognized statistical rating organizations, NAIC designations are not suitable for use by anyone other than NAIC members." (Tr., pp. 213-214) Since no party to this case is an insurance regulator and therefore an NAIC member, the NAIC ratings should not be used in this proceeding. (Tr., pp. 181-182)

The Company's argument that Ms. Kight should have relied on NAIC's alleged numeric designation of 2 for three of CIWC's debt issues, which the Company contends is equivalent to an S&P rating of BBB, is disingenuous because Ms. Ahern's own risk premium analysis is based on a credit rating of A.

(CIWC Brief, p. 34; CIWC Ex. 3.0, p. 38 and Sch. 13, p.2) Further, Ms. Ahern testified that "Ms. Kight's implied credit rating of A+ for CIWC, and therefore likely bond rating, and business position of 3 are consistent with the average S&P bond ratings and assigned business positions of both my proxy groups which are shown as A+ and "2.8" ("3" rounded) for the water group and A and "3.3" ("3" rounded") for the thirteen utilities." (CIWC Ex. R-3.0, p.12) Clearly, Ms. Ahern's own analysis and proxies demonstrates risk commensurate with an A-rating is appropriate. It is of further significance that Ms. Ahern made no adjustment to her cost of equity recommendation to reflect the increased risk of the BBB rating. Finally, the Company provided no documentation from S&P or from the NAIC that an S&P rating of BBB and an NAIC rating of 2 are equivalent. Instead, Ms. Ahern relied upon a third party document which, by her own admission, states that NAIC and S&P ratings are not determined based on the same assessment of risk. (Tr., p. 183-184)

The Company implied that since Ms. Kight did not speak to any analyst from S&P, Moody's, or Fitch about CIWC's corporate credit rating, her determination of CIWC's financial strength should not be accepted. However, CIWC is not rated; hence, there would be no one at the rating agencies to talk to about CIWC. Nevertheless, Ms. Kight did talk to an analyst at S&P regarding

CIWC's ultimate parent company, Philadelphia Suburban Corp., and its credit-rated subsidiary, Pennsylvania Suburban Water Company. (Tr., pp. 232, 264-265)

The Company contended that Ms. Kight's cost of equity is substandard because she used an imputed S&P credit rating as the basis for forming her samples. The Company further asserted that Ms. Kight ignored CIWC's business risk, which led her to understate CIWC's cost of equity. (CIWC Brief, pp. 35-36) Once again, the Company's contentions are without merit. In light of the fact that CIWC does not have an S&P business position score, Ms. Kight took the logical, common sense approach of examining the S&P business position scores of other water utilities. Ms. Kight found that of the 11 water utilities with business profiles scores, 3 have scores of 2 and 8 have scores of 3. (ICC Staff Ex. 3.0C, pp. 9-10) Ms. Kight's methodology for determining her comparable sample using imputed credit ratings and business profiles in order to determine a company's cost of equity was approved by the Commission in Docket Nos. 02-0690 and 02-0592. (Order, Docket 02-0690, August 2, 2003, p. 78; Order, Docket 02-0592, April 9, 2003, p. 6) Significantly, the Company presented no evidence that Ms. Kight's water and utility samples are less risky than CIWC while Ms. Kight's water sample is identical to Ms. Ahern's water sample. (ICC Staff Ex. 3.0C, p. 13; CIWC Ex. 3.0, Sch. 13, p.2)

In the first sentence of the first full paragraph on page 36 of its Initial Brief, the Company states “Quantification of the impact of the faculty evidence is decreased in Ms. Ahern’s testimony.” (CIWC Brief, p. 36) It is unclear to Staff what Company’s intended meaning is with regard to this statement. As such, Staff is unable to respond to this argument.

2. Alleged Exclusive Reliance on DCF Model

The Company contended that Ms. Kight relied exclusively on the DCF model for her cost of equity recommendation and that the DCF understates investors’ required rate of return. (CIWC Brief, pp. 36-39) These contentions were addressed in Staff’s Initial Brief on pages 37-41. In addition, the Company misquoted the Commission’s Commonwealth Edison Company’s Order in Docket No. 94-0065 in which the Commission had rejected the use of the DCF that assumes dividends are paid annually. The Company omitted the portion of that Order in which the Commission accepted Mr. Pregozen’s cost of equity recommendation based on the DCF and CAPM, the same models Ms. Kight used. (Order, Docket No. 94-0065, January 9, 1995, pp. 86 and 94) Ms. Kight did not use an “annual” DCF model; rather, her DCF model reflected the quarterly frequency of dividend payments. Staff’s use of the DCF and CAPM models to determine a companies cost of equity has been approved by the Commission in numerous proceedings, such as Docket Nos. 02-0837, 02-0690, 02-0592, 00-0340, 00-0337/00-0338/00-0339 Consolidated, 99-0288, and 98-0632, just to name a few.[4]

The Company supplements its argument against the DCF with Orders from three other state Commissions. (CIWC Brief, pp. 37-38) The Company's reliance on these orders is misplaced. First, the cited decisions conflict with established Commission practice. Secondly, Illinois is not bound by other states' Commission decisions. Further, there are certainly other state jurisdictions that use the DCF, such as Massachusetts, New York, Utah, and West Virginia.[5] Thus, the Company's attempt to cite a select number of opinions from other states is not a useful exercise, particularly since contradicting opinions from still other states are easy to find.

3. Staff's Betas

The Company argued that Ms. Kight should have used widely available and investor influencing Merrill Lynch betas instead of calculating her own. (CIWC Brief, p.40) The objective of rate of return analysts is to discern investors' required rate of return based on observable market prices. Nothing in financial theory posits that it is inappropriate for an investor (or analyst) to calculate her own betas. In Docket No. 00-0340 the Commission concluded, "Staff's

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[4] Order, Docket No. 02-0837, October 17, 2003, p. 38; Order, Docket No. 02-0690, August 12, 2003, p. 81; Order, Docket No. 02-0592, April 9, 2003, pp. 6-7; Order, Docket No. 00-0340, February 15, 2001, pp. 12, 24-25; Order, Docket No. 00-0337/00-0338/00-0339 Consolidated, January 31, 2001, p. 8; Order, Docket No. 99-0288, March 1, 2000, pp. 21-22; and Order, Docket No. 98-0632, March 24, 1999, pp. 5-6.

[5] Order, Docket No. DTE 03-40, Commonwealth of Massachusetts Department of Telecommunications and Energy, October 31, 2003; Order, Case 02-E-0198 and 02-G-0199, New York Public Service Commission, March 7, 2003; Order, Docket No. 02-057-02, Utah Public Service Commission, December 30, 2002; Order, Case No. 03-0353-W-42T, Public Service Commission of West Virginia, January 2, 2004.

calculation of betas reasonable. Staff has calculated sample betas in prior numerous rate cases. There is no presumption that either Value Line betas or calculated betas is superior as long as the underlying calculation is valid." (Order Docket No. 00-0340, February 15, 2001, p. 25) Ms. Kight demonstrated that her calculations of beta are consistent with published sources. Significantly, the Company did not challenge the validity of her methodology. In addition, Ms. Kight demonstrated that the Merrill Lynch and published Yahoo betas are lower than her regression betas; hence, if she were to include the Yahoo/Merrill Lynch betas in her CAPM analysis, as the Company suggest, either as additions to, or substitutes for, her regression betas, her CAPM-derived cost of common equity estimate would be lower rather than higher. (ICC Staff Ex. 9.0, pp.10-12)

B. Summary

Staff has clearly demonstrated that the appropriate cost of common equity for CIWC is 9.86%. Staff has shown that the Company' methodology is flawed and its criticisms of Staff methodology are without merit. Based on the evidence and arguments presented by Staff and the weakness of the Company's position, the Commission should adopt Staff's cost of equity proposal of 9.86% and the resulting overall cost of capital of 8.87%.

V. COST OF SERVICE STUDY/RATE DESIGN

In its Initial Brief, the Company maintained that its proposed across-the-board percentage increase for all rates is a better method for increasing rates in this docket than Staff's test year cost of service study ("COSS"). (CIWC Brief, pp.

41-45) Staff explained why the test year COSS should be used to determine rates based upon test year revenue requirement (Staff Brief, pp. 44-49)

The Company offers two reasons for an across-the-board percentage increase rather than specific increases based upon the Staff COSS: First, that large water customers absorb larger percentage increases than residential customers under the Staff COSS, and second, comments from large water customers during the public hearing on this docket describe those customers' dissatisfaction with being faced with a larger increase than residential customers.

After stating the percentage increase for each customer class in Staff's COSS[6], the Company offers the logic that "such a disproportionate increase on the Industrial class of customers will negatively affect the industrial base in Kankakee" (CIWC Brief, p. 41), but does not discuss whether the Company's proposed increase would negatively impact the industrial base in Kankakee. Certainly, an increase of any amount is not likely to provide an economic benefit to any given customer class, but the Company's discussion provides little insight into whether the Company's proposed across-the-board increase is any less damaging to the Kankakee economy which obviously includes not only large industrial customers, but also residential and small commercial customers.

Staff's proposed 35.1% increase is not drastically greater for the industrial customer class than the Company's 29.5% across-the-board increase in base rates, which include the customer charge and usage charges. Both the Company and Staff increases roll-in revenues from the Qualifying Infrastructure

[6] The Company provided the wrong reference to Staff testimony detailing the percentage increases. The reference should be ICC Staff Ex. 10.1, page 2.

Plant ("QIP") charge currently in effect to base rate revenues, which explains why Staff describes the Company's across-the-board increase as a 29.5% increase in base rates rather than the Company stated 24.14% overall increase in annual revenue. Staff's proposed increase for the industrial class, if the roll-in of QIP revenues is added to revenues paid under current rates, is reduced to 29.9% of current industrial revenues (ICC Staff Ex. 10.1, p. 2, Staff Industrial Revenues divided by Present Industrial Revenues increased by the 1.0401 QIP surcharge).[7]

The industrial customer comments quoted by the Company seem to indicate a misunderstanding of the amount that industrial customers pay for water service compared to residential customers (Staff Brief, p. 48). On a percentage basis, Staff's proposed increase for large customers is higher than for small customers, but on a per-unit basis, Staff's proposed increase for small customers is higher than for large customers (Id.). With a per-unit increase higher than the per-unit increase to industrial customers, residential customers are picking up the bulk of the rate increase under Staff's rates, at 52% of the increase for residential customers compared to 17% of the increase for industrial customers.[8] The average amount that residential customers would pay per unit of water is more than triple the average amount that industrial customers would pay under Staff's proposed rates (Staff Brief, p. 48).

Because the current amount that industrial customers pay per unit of water is so much less than the current amount that residential customers pay, the

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[7] $1,741,387 divided by ($1,288,582 x 1.0401 QIP = $1,340,254) = 1.2993.

[8] From ICC Staff Ex. 10.1, page 2; subtract present revenues from Staff revenues for residential, industrial, and total revenues to determine increases. $1,357,270 residential increase = 52.22% of $2,599,130 total increase, $452,805 industrial increase = 17.42% of $2,599,130 total increase.

percentage increase to industrial customers is higher than the percentage increase to residential customers, despite the higher actual increase to residential customers. Thus, the concerns expressed by industrial customers that Staff's proposed rates "charge business and industry more than we charge the residents" and that business and industry will be penalized by "a higher rate than anyone else" (Id., p. 49) are inaccurate. Other concerns expressed by industrial customers and quoted by Consumers about business being "a fall guy for the budget deficit in Springfield" because of increases in taxes, fees, and the minimum wage (Id.) have little, if anything, to do with the Company-proposed rate increase under review in this docket. However the rate increase is distributed among Kankakee customer groups, it is the Company that initiated this increase in business expenses for water supply, not the Commission and not "Springfield". The Company should not blame Staff or the Commission for increases in rates to large customers, smaller commercial customers, or residential customers.

Business groups were not the only interests represented at the Public Forum on the proposed Consumers rate increase. Residential groups described the difficulties of paying for an increased water bill in the face of incomes that do not keep pace with other increasing costs, or having to choose between what probably would be considered necessary goods and services such as heat, electricity, or medicine (Tr., Public Hearing, October 29, 2003, pp. 12-14, 17-19, 33-35, and 42). The variety of customer groups represented at the public hearing on Consumers Kankakee rate increase illustrates that the proposed increase adversely affects all customer groups.

Staff's COSS should be used to determine rates in this docket because it measures test year costs of the Consumers Kankakee water system based upon test year usage of the Kankakee water system. If the Commission views Staff's proposed increase to large water users excessive compared to the increase applicable to smaller commercial and residential customers, rates should be based upon Staff's alternative rate design (Staff Brief, pp. 49 and 50). Staff's alternative rate design reduces the amount of the increase to large customers at the expense of smaller customers, but moves the rates that large customers pay closer to test year cost of service than the Company's proposed across-the-board increase. (Id.)

VIII. CONCLUSION

For the reasons set forth above, Staff respectfully requests that the Commission approve the proposed Tariffs for the Company, only if Staff's modifications are incorporated.

Respectfully submitted,

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